FEDERAL TAXATION: FORMAL STOCKHOLDER VOTE HELD CONTROLLING IN DETERMINING WHEN A PLAN OF LIQUIDATION IS ADOPTED UNDER SECTION 337 OF THE INTERNAL REVENUE CODE OF 1954

SECTION 337 (a) of the Internal Revenue Code of 1954 provides that if a corporation adopts a plan of complete liquidation and distributes all its assets pursuant to that plan within twelve months, no gain or loss will be attributed to it from the sale of its property within that period.[1] Of the many problems involved in the interpretation of this section,[2] one of the most perplexing has been the determination of what factors are to be considered in establishing the date on which a plan of liquidation is adopted.[3] The Tax Court of the United States addressed itself to this question in the recent case of *City Bank of Washington*.[4]

The stipulated facts of the *City Bank* case show that representatives of the City Bank of Washington (City Bank) had from time to time discussed with representatives of American Security and Trust Company (American Security) and its affiliate, American Security Corporation (Affiliate), the possibility of merging City Bank and American Security. On March 25, 1959, a "Basic Memorandum Agreement" was executed in behalf of City Bank, American Security, and the Affiliate, under which American Security and/or the Affiliate agreed to purchase all the assets of City Bank and to assume all its liabilities. By April 10, 1959, an offer by the Affiliate to purchase all the stock of City Bank had been accepted by holders of over

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[1] (a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period. INT. REV. CODE OF 1954, § 337 (a).

[2] For a discussion of several problems, see Bennion, *Sale of Corporate Assets Under Section 337*, U. SO. CAL. 1958 TAX INST. 253.

[3] The adoption date is significant in determining a corporation's tax liability, not only because it launches the twelve-month period but also because it determines which sales come under the nonrecognition provision of the statute. See Pustilnik, *Liquidation of Closely-Held Corporations Under Section 337*, 16 TAX L. REV. 255, 256-57 (1961).

[4] 38 T.C. No. 72 (Aug. 23, 1962).

three fourths of the outstanding shares. On May 26, 1959,[5] three days before the formal vote by its stockholders approving resolutions for the sale of the corporation's assets and the plan of voluntary liquidation, City Bank sold certain of its United States Treasury bonds and notes at a large net loss.[6] The remainder of its assets, however, were sold for a gain after the formal adoption of the plan, effectuating what Bittker calls a "straddle" sale.[7] In its federal income tax return for the period ending May 29, 1959, City Bank claimed a deduction in the amount of the loss sustained in the May 26 sale of the notes and bonds but did not return the gains recognized in the subsequent sale of the other assets. The Commissioner disallowed the deduction on the ground that a plan had been informally adopted prior to the loss sale and that the loss as well as the subsequent gains qualified for nonrecognition of gain or loss under section 337 (a). Thus, in a petition for redetermination, the court was presented with the question of when the plan of complete liquidation of City Bank was adopted. The Tax Court, stating that "the general intention to liquidate is not the adoption of a plan of liquidation,"[8] denied the Commissioner's contention by holding that the date of the adoption was the date of the formal stockholder resolution and hence City Bank was entitled to deduct its loss from the sale of the securities.

The purpose and history of section 337 (a) play a significant part in an analysis of the decision in the instant case. Before the adoption of the Internal Revenue Code of 1954, there were three ways to dispose of a corporate business: (1) the individual shareholders could sell their stock; (2) the shareholders could cause the corporation to liquidate its assets in kind and then individually sell them; or (3) the corporation could sell its assets and then distribute the

[5] By May 26, the Affiliate not only controlled 79% of City Bank's stock directly but also controlled 20% indirectly through an underwriting agreement. Less than 1% was still held by original stockholders. 38 T.C. No. 72 (Aug. 23, 1962).

[6] Under § 582 of the 1954 Code, which applies only to banks, net capital losses on the sale or exchange of bonds or other evidences of indebtedness are allowed in full against other income. In the instant case, City Bank claimed that a plan of complete liquidation was not adopted until May 29, 1959, the date of the formal stockholder vote, and that the sale of the bonds and notes was thus exempt from § 337.

[7] BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 292 (1959).

[8] 38 T.C. No. 72 (Aug. 23, 1962).

proceeds in liquidation.[9] Under the first two procedures, a capital gains tax was paid only by the shareholders. However, under the third procedure, both the sale of corporate assets before liquidation and the subsequent distribution to the shareholders were taxable transactions.[10] Therefore, the question of whether a transfer was a corporate sale or merely a shareholder sale was critical in assessing a corporation's tax liability. Out of the numerous decisions dealing with this question, there arose confusion, uncertainty, and a resulting unsatisfactory dependence on formalities in arranging liquidation sales.[11] In order to provide a definitive rule which would eliminate the existing confusion, Congress enacted section 337.[12] However, it failed to specify how to determine when a plan is adopted, and the aspiration for a definitive rule went unrealized.[13]

In an attempt to solve the problem by introducing some guides by which an adoption date could be determined, regulations were proposed which fixed the date of adoption of a plan as "the date on which occurs the first step in the execution of such plan, but not later than the date of the adoption of the resolution by the shareholders . . . ."[14] The proposed regulations, however, were not ac-

[9] Gelberg, *The Court Holding Cumberland Situation: Liquidation as an Incident to Sale of Assets*, N.Y.U. 13TH INST. ON FED. TAX 605 (1955).

[10] A corporate tax, generally at capital gains rates, was imposed on the excess of the proceeds of the sale over the corporation's basis of the property sold; moreover, the shareholder was taxed in the same fashion on the excess of the proceeds of the sale over the basis of his stock. *Id.* at 606.

[11] *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945), *with* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). In the *Court Holding* case, the corporation engaged in preliminary negotiations for the sale of its assets before transferring them to its shareholders who then made the sale. The Court held that the sale was in fact a corporate sale and should be taxed as such. In the *Cumberland* case, however, the Court distinguished very similar facts and held that the sale of the assets by the shareholders after transfer to them in liquidation should be considered a shareholder sale, even though the transaction was admittedly for the purpose of reducing taxes.

As a result, taxpayers were virtually compelled to follow the pattern of the *Cumberland* case in order to avoid the double taxation, and, even in the observance of these formalities, they were rarely confident of the outcome. See MacLean, *Taxation of Sales of Corporate Assets in the Course of Liquidation*, 56 COLUM. L. REV. 641, 642 (1956). See generally Beck, *Newer Methods to Avoid the Court Holding Company Problems. Does a Case Like Westover v. Smith Eliminate the Court Holding Company Problem?*, N.Y.U. 8TH INST. ON FED. TAX 955 (1950).

[12] S. REP. No. 1622, 83d Cong., 2d Sess. 49, 258 (1954).

[13] See generally Bennion, *supra* note 2.

[14] Proposed Treas. Reg. § 1.337-2 (b), 19 Fed. Reg. 8262 (1954). The proposed regulations also provided that consideration would be given to the dates of any sales of property not ordinarily made in the conduct of business as well as to all other relevant facts and circumstances. For an article advocating the adoption of the approach of the proposed regulations, see Pustilnik, *supra* note 3.

cepted by the Treasury Department. The regulations which were promulgated place more emphasis on formalities by providing that a stockholder vote is controlling in "ordinary" cases and substance is controlling in all other cases.[15] However, the regulations neither clearly define "ordinary" cases nor specify what facts and circumstances are relevant in situations which are not "ordinary."

Very few cases have been decided since 1954 involving the question of when a plan is adopted, and taken together they offer little controlling precedent for the courts. In *Virginia Ice & Freezing Corp.*[16] the court held that the date of the adoption of a plan of liquidation was the date of the formal stockholder vote even though certain assets were sold for a loss at an earlier date.[17] On the other hand, it was held in *Mountain Water Co.*[18] that the adoption date is dependent on the facts in each case and that a formal shareholder vote is not necessarily controlling.[19] There seem to be no cases holding that formal stockholder action should be controlling in all situations nor any cases precisely defining what type of facts and circumstances are necessary to shift the date of adoption to a date earlier than formal stockholder action.[20]

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[15] "Ordinarily the date of the adoption of a plan of complete liquidation by a corporation is the date of adoption by the shareholders of the resolution authorizing the distribution of all the assets of the corporation . . . in redemption of all of its stock. Where the corporation sells substantially all of its property . . . prior to the date of adoption by the shareholders of such resolution . . . [or] where no substantial part of the property . . . has been sold by the corporation prior to the date of adoption by the shareholders of such resolution, the date of the adoption of the plan of complete liquidation by such corporation is the date of adoption by the shareholders of such resolution . . . . In all other cases the date of the adoption of the plan of liquidation shall be determined from all facts and circumstances." Treas. Reg. § 1.337-2 (b) (1955).

[16] 30 T.C. 1251 (1958).

[17] "Until then there was no assurance that the recommendation of the board of directors . . . would be adopted by the stockholders." *Id.* at 1257.

Virginia Ice can be distinguished from the instant case in that the officers and directors owned only about 15% of the outstanding shares at the time of the loss sale, the other 85% being widely dispersed among twenty-six stockholders. It was therefore much more difficult to find that a plan had been adopted, since approval by the stockholders was not virtually certain at the date of the loss sale as it was in *City Bank.* See Bittker, *op. cit. supra* note 7, at 293. Pustilnik, *supra* note 3, at 263, 293.

[18] 35 T.C. 418 (1960), *acq.*, 1961-1 CUM. BULL. 4.

[19] The *Mountain Water* case is distinguishable from the instant case in that no liquidating resolution was ever adopted by the stockholders. *Id.* at 427.

[20] *But see* Rev. Rul. 57-140, 1957-1 CUM. BULL. 118 which enumerates facts and circumstances which show that there was no intention to liquidate at the time of the loss sale.

For cases which have held that the formal date of adoption is not necessarily controlling, see Whitson v. Rockwood, 190 F. Supp. 478 (D.N.D. 1960); Powell's Pontiac-

Congressional intent should, of course, be a paramount factor in construing any statute. However, the only clue to congressional intent here is the noticeable omission in section 337 (a) of any requirement of formality. This omission is significant since the original House bill did require that a sale follow the adoption of a formal liquidation resolution by the board of directors or the stockholders in order to qualify for nonrecognition.[21] Had Congress intended to require that a formal plan be controlling in all cases, it would seem that such a provision would have remained in the statute.

Within this context of uncertainty, convincing arguments can be advanced both for and against the Tax Court construction of section 337 (a). In deciding for the taxpayer, the court pointed out that the Commissioner's approach "would hardly make for certainty,"[22] and no doubt certainty is desirable in statutory law. Since the date of adoption launches the twelve-month period, setting the date back might result in the failure of the corporation to completely liquidate within the time allotted.[23] The commentators, on the other hand, were almost unanimous in their anticipation that, given facts analogous to those in the instant case, the date of adoption of a plan of complete liquidation would be the date of the loss sale.[24] They pointed out that under the regulations, a "straddle" situation such as presented in the instant case, should not be classified as "ordinary," but should be considered in the category that requires all the facts and circumstances to be examined.[25] Indeed, this category was seemingly included in the regulations for the specific purpose of closing the conspicuous "straddle" loophole in the statute.[26]

Cadillac, Inc. v. Gross, 5 Am. Fed. Tax. R.2d 977 (D.N.J. 1960); Intercounty Development Corp., 30 P-H Tax Ct. Mem. 1171 (1961).

[21] H.R. 8300, 83d Cong., 2d Sess. § 336 (1954).

[22] 38 T.C. No. 72 (Aug. 23, 1962).

[23] For a discussion of this point, see Editorial Note, 23 GEO. WASH. L. REV. 701, 711-12 (1955).

[24] See, *e.g.*, Bennion, *supra* note 2, at 258 (date of adoption may well be deemed to be date of loss sale); Garver, *Liquidations Under Section 337*, 13 W. RES. L. REV. 245, 249 (1962) (would seem reasonable); MacLean, *supra* note 11, at 648 (a court might well find); Editorial Note, 23 GEO. WASH. L. REV. 701, 714 (1955) (a much more reasonable answer to this problem). *But see* Paulston, *How to Plan and Execute the Sale of a Corporate Business Under the Internal Revenue Code of 1954*, U. SO. CAL. 1956 TAX INST. 383, 419.

[25] See, *e.g.*, BITTKER, *op. cit. supra* note 7, at 292. *But see* Brief for Petitioner, pp. 73-74, where it is argued that the facts of the *City Bank* case place it in the "ordinary" group of cases.

[26] If closing the loophole were not the purpose, there is no apparent reason for the

Since neither the decided cases, nor the legislative history, nor even the regulations are conclusive as to congressional intent, the ramifications of the *City Bank* decision should be carefully examined in the light of general tax objectives.[27] That Congress intended to instill certainty in an area clouded by uncertainty cannot be denied.[28] However in weighing the advantages of certainty against the possibility of a significant tax disortion,[29] one might well conclude that certainty should be sacrificed. To make formalities controlling in a "straddle" sale, as the instant case appears to do, allows a corporation both to sell appreciated assets without realizing a taxable gain and to deduct from previously earned income losses from the sale of depreciated assets. Such a consequence results in an inequitable distribution of the tax burden and therefore seems incompatible with congressional taxation objectives.[30]

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distinction between sales made either before or after the formal adoption and sales made both before and after such adoption. See MacLean, *supra* note 11, at 644.

[27] Under the reasoning of this decision, a corporation will be able to arrange all the details of liquidation, insure stockholder approval, and determine and sell its "loss" assets shortly before a formal stockholder vote, thus obtaining recognition of its losses without a parallel recognition of its gains.

[28] See S. REP. No. 1622, 83d Cong., 2d Sess. 49, 258 (1956).

[29] See MacLean, *supra* note 11, 647 & n. 17, for a hypothetical example of a tax distortion by a "straddle" procedure.

[30] "Whenever taxation is allowed to depend upon form, rather than substance, the door is opened wide to distortions of the tax laws which, after all, represent the legislative judgment for an equitable distribution of the tax burden generally." Landa v. Commissioner, 211 F.2d 46, 50 (D.C. Cir. 1954).